

# Enforcement

## Overview

*“These days, the concept of effective enforcement necessarily includes ‘seeing around the corner.’ What that means to us is identifying trends, practices, and risks within our capital markets that could be exploited to the detriment of investors. Ideally, if we are able to spot these issues in their infancy, we can prevent them from growing into full-fledged, confidence-eroding scandals.”*

Stephen M. Cutler, Director  
Division of Enforcement

935 enforcement staff:

- Obtained orders in SEC judicial and administrative proceedings requiring securities violators to disgorge illegal profits of approximately \$900 million and to pay penalties of approximately \$1.1 billion.
- Sought orders barring 170 defendants and respondents from serving as officers or directors of public companies.
- Sought emergency relief from federal courts in the form of temporary restraining orders (TROs) to halt ongoing fraudulent conduct in 35 actions, and sought asset freezes in 39 actions.
- Filed 12 actions to enforce investigative subpoenas.
- Halted trading in securities of 13 issuers about which there was inadequate public disclosure.

In SEC-related criminal cases, prosecutors filed indictments, informations, or contempts against 246 individuals or entities.

## Key Results

Case	Result
Enron Cases	The Commission filed 7 separate actions against 14 individuals, 13 of whom have also been charged criminally; three financial institutions also included in the actions collectively have paid \$316 million to be returned to defrauded investors.
Research Analyst Cases	In cooperation with other regulators, the Commission obtained injunctions against 10 investment banks and 2 individual research analysts, and orders for payments totaling \$1.4 billion, including \$894 million in disgorgement and penalties (\$399 million of which will be paid to investors), \$432.5 million to fund independent research, and \$80 million to promote investor education.
Xerox Cases	The Commission brought fraud charges against Xerox's auditor; it also, in an action against 6 senior Xerox executives, obtained settlements resulting in injunctions, officer and director bars, payments totaling \$22 million, and bars for two executives from practicing as accountants before the Commission.

---

Main Activities	Fiscal 2003	Fiscal 2002	% Change
Civil Injunctive Actions	271	270	0%
Administrative Proceedings	365	281	+30%
Contempt Proceedings	42	47	-11%
Reports of Investigation	1	1	0%

## Significant Enforcement Actions

Many of the SEC's enforcement actions were resolved by settlement with the defendants or respondents, who generally consented to the entry of judicial or administrative

orders without admitting or denying the allegations against them. The following is a sampling of the year's significant actions.

### Financial Fraud and Disclosure

*SEC v. Brightpoint, Inc., et al.*<sup>1</sup> The Commission filed a civil enforcement action, and instituted four settled administrative proceedings, against American International Group, Inc. (AIG) and Brightpoint, Inc., as well as three former employees of Brightpoint, and one AIG employee, for their roles in fraudulently manipulating Brightpoint's earnings. All but one defendant settled the Commission's action. The Commission alleged that AIG sold a retroactive insurance policy to Brightpoint, allowing the company to cover-up \$11.9 million in losses sustained by one of its foreign subsidiaries. As a result, Brightpoint's 1998 financial statements overstated the company's net income before taxes by 61%. In connection with the settlements, AIG agreed to pay a civil penalty of \$10 million.

*SEC v. J.P. Morgan Chase & Co.*<sup>2</sup>; *In the Matter of Citigroup, Inc.*<sup>3</sup> The Commission filed and settled enforcement proceedings against J.P. Morgan Chase & Co. and Citigroup, Inc. for their respective roles in the manipulation of the financial statements of Enron Corp., and Citigroup's role in the manipulation of the financial statements of Dynegy Inc. The Commission alleged that the defendants engaged in complex structured finance transactions designed to help their clients inflate reported cash flow from operating activities, underreport cash flow from financing activities, and underreport debt. J.P. Morgan agreed, in a civil action, to an antifraud injunction and to pay \$135 million to settle the Commission's action over its conduct relating to Enron; and Citigroup agreed, in an administrative proceeding, to

a cease-and-desist order and to pay \$101 million to settle the Commission's action over its conduct relating to Enron and Dynegy.

*SEC v. Henry C. Yuen and Elsie M. Leung.*<sup>4</sup> The Commission filed a civil action against two former top executive officers of Gemstar-TV Guide International, Inc., Henry C. Yuen and Elsie M. Leung, alleging that they used a variety of tactics to overstate Gemstar's total revenues by at least \$223 million from March 2000 through September 2002, and that they reaped millions of dollars in financial gains from their fraudulent scheme because their compensation was tied to Gemstar's financial performance. Upon motion of the Commission pursuant to Section 1103 of the Sarbanes-Oxley Act of 2002, the court placed into escrow nearly \$38 million in cash payments that the company had previously agreed to pay the defendants. This litigation is ongoing.

*SEC v. Paul A. Allaire, et al.*<sup>5</sup> The Commission filed and settled a civil action against six former senior executives of Xerox Corporation, including its former chief executive officers Paul A. Allaire and G. Richard Thoman, and its former chief financial officer Barry D. Romeril, alleging that they engaged in a fraudulent scheme from 1997 to 2000 that misled investors about Xerox's earnings in order to polish its reputation on Wall Street and boost the company's stock price. The Commission alleged that the scheme involved the use of accounting devices that were not disclosed to investors, many

of which violated Generally Accepted Accounting Principles (GAAP), that were responsible for accelerating the recognition of equipment revenues by approximately \$3 billion and increasing pre-tax earnings by \$1.4 billion in Xerox's 1997-2000 financial results. In addition to injunctions, the defendants agreed to pay over \$22 million in civil penalties, disgorgement, and interest.

*SEC v. Kevin A. Howard, et al.*<sup>6</sup> The Commission filed two related civil actions against seven former top executives of Enron Broadband Services, Inc. (a wholly-owned subsidiary of Enron Corp.), Kevin A. Howard, Michael W. Krautz, Kenneth D. Rice, Joseph Hirko, Kevin P. Hannon, Rex T. Shelby, and F. Scott Yeager. In the first action, the Commission alleged that Howard and Krautz engaged in a scheme that involved the sham sale of certain assets to accelerate recognition of income, which resulted in Enron overstating its reported net income by \$111 million for the fourth quarter of 2000 and the first quarter of 2001. In the second action, the Commission alleged that Rice, Hirko, Hannon, Shelby, and Yeager engaged in a fraudulent scheme to, among other things, inflate the value of Enron stock through a series of false and misleading statements, and the omission of material information, in public statements about the technology, financial condition, performance, and value of Enron Broadband. This litigation is ongoing.

*SEC v. HealthSouth Corporation, et al.*<sup>7</sup> The Commission, in four related

civil actions, charged HealthSouth Corporation, its CEO and Chairman Richard M. Scrushy, and eight other HealthSouth officers and employees, with systematically overstating HealthSouth's earnings by at least \$1.4 billion since 1999. The Commission alleged that the defendants engaged in a scheme to falsify and misrepresent HealthSouth's financial results and thereby enrich themselves and keep their jobs. The Commission is seeking injunctions, officer and director bars, disgorgement of all ill-gotten gains and losses avoided, and civil penalties.

*SEC v. Merrill Lynch & Co., Inc., et al.*<sup>8</sup> The Commission filed a civil action against Merrill Lynch & Co., Inc. and four of its former senior executives, alleging that the defendants aided and abetted Enron Corp.'s earnings manipulation by engaging in two fraudulent year-end transactions in 1999. The transactions had the purpose and effect of overstating Enron's reported financial results by adding approximately \$60 million to its fourth quarter of 1999 income. Merrill Lynch agreed to pay \$80 million in disgorgement, penalties and interest, and to the entry of a permanent anti-fraud injunction. The four former Merrill Lynch executives named in the complaint, Robert S. Furst, Schuyler M. Tilney, Daniel H. Bayly and Thomas W. Davis, are contesting the matter.

*SEC v. Joel M. Arnold, et al.*<sup>9</sup> The Commission filed a civil action against eight current and former officers

and employees of Qwest Communications International, Inc., alleging that they inflated the company's revenues by approximately \$144 million in 2000 and 2001 in order to meet earnings projections and revenue expectations. The Commission's complaint alleges that the defendants artificially accelerated Qwest's recognition of revenue in two equipment sale transactions for its Global Business Markets unit. When Qwest and Global Business determined that Qwest was falling short of its quarterly revenue targets and would not achieve the projected growth for the quarters ending June 30, 2001 and September 30, 2000, the defendants bridged the revenue gap by fraudulently mischaracterizing these transactions. The Commission is seeking anti-fraud injunctions, officer and director bars, civil money penalties, and disgorgement of ill-gotten gains (including compensation, bonuses, and stock trading profits during the relevant period).

*SEC v. Andrew S. Fastow.*<sup>10</sup> The Commission filed a civil action against Andrew S. Fastow, the former chief financial officer of Enron Corp., alleging that Fastow and others used complex structures, straw men, hidden payments, and secret loans to create the appearance that certain entities funded by Fastow and others at Enron were independent of Enron. This allowed Enron to move its interest in these entities off its balance sheet when, in fact, those interests should have been consolidated into Enron's financial statements.

This was done, the Commission alleges, for self-enrichment and to mislead analysts, rating agencies, and others about Enron's true financial

condition. The Commission is seeking an injunction, officer and director bar, disgorgement of all ill-gotten gains, and civil penalties.

## Cases Involving Accountants and Auditors

*In the Matter of Thomas C. Trauger and Michael Mullen; In the Matter of Oliver Flanagan.*<sup>11</sup> The Commission instituted two related administrative proceedings against three individuals for their conduct in the alleged alteration and destruction of the working papers for Ernst & Young, LLC (E&Y) client NextCard, Inc. In the first proceeding, the Division of Enforcement alleged that Thomas Trauger, a former audit partner with Ernst & Young, LLC, directed Michael Mullen, an E&Y audit manager, to alter E&Y's work papers for the fiscal year 2000 audit of NextCard. In the second proceeding, settled at the time of institution, the Commission found that Oliver Flanagan destroyed certain audit working papers. Flanagan consented to an order denying him the privilege of practicing before the Commission, with the right to reapply after three years.

*In the Matter of Pricewaterhouse-Coopers LLP.*<sup>12</sup> The Commission instituted settled administrative proceedings against Pricewaterhouse-Coopers LLC (PWC) and Philip Hirsch, finding that PWC, through Hirsch, failed to comply with Generally Accepted Accounting Standards in connection with its audit of SmarTalk TeleServices, Inc.'s 1997 year-end financial statements. The Commission

also found that after PWC became aware of a class action shareholder lawsuit alleging fraud against SmarTalk, PWC made revisions to its working papers and discarded other documents relevant to its audit. PWC agreed to a censure, to significant remedial undertakings, and to pay a \$1 million penalty; and Hirsch agreed to an order denying him the privilege of practicing before the Commission, with the right to reapply after one year.

*SEC v. Kenneth Wilchfort, et al.*<sup>13</sup> The Commission filed and settled a civil action against two E&Y partners, Kenneth Wilchfort and Marc Rabinowitz, in connection with audits of Cendant Corporation, and its predecessor CUC International. The Commission alleged that the two partners aided and abetted Cendant's and CUC's violations of the reporting provisions of the federal securities laws by failing to detect that their financial statements were not presented in conformity with GAAP. In separate administrative proceedings, Wilchfort and Rabinowitz also consented to orders suspending them from appearing or practicing before the Commission as accountants, with the right to reapply after four years.

*SEC v. KPMG LLP, et al.*<sup>14</sup> The Commission filed a civil action against KPMG LLP and four KPMG partners—including the

head of the firm's department of professional practice—in connection with KPMG's audits of Xerox Corporation from 1997 through 2000. The complaint alleges that the defendants permitted Xerox to manipulate its accounting practices to close a \$3 billion

gap between actual operating results and results reported to the investing public. The defendants' actions inflated pre-tax earnings by approximately \$1.2 billion in Xerox's 1997 through 2000 financial results. This litigation is ongoing.

## Foreign Payments Cases

*In the Matter of American Rice, Inc., et al.*<sup>15</sup> The Commission issued a cease-and-desist order against American Rice, Inc. and three of its employees, Joseph A. Schwartz, Joel R. Malebranche, and Allen W. Sturdivant, finding that the employees participated in a scheme to illegally reduce American Rice's import taxes by approximately \$1.5 million on rice shipments to Haiti by paying at least 12 bribes to Haitian customs officials totaling approximately \$500,000, and that Schwartz improperly recorded the bribery payments as routine business expenditures.

*SEC v. Syncor International Corp.*<sup>16</sup> The Commission filed and settled enforcement proceedings charging Syncor International Corporation with violating the Foreign Corrupt Practices Act (FCPA). The Commission filed a civil action

alleging that several Syncor subsidiaries made a total of at least \$600,000 in illicit payments to doctors employed by hospitals controlled by foreign authorities. The Commission also issued an administrative order finding that Syncor violated the anti-bribery, books and records, and internal controls provisions of the FCPA, ordering Syncor to cease and desist from such violations, and requiring Syncor to retain an independent consultant to review and make recommendations concerning the company's FCPA compliance policies and procedures. Without admitting or denying the Commission's charges, Syncor consented to the entry of a final judgment in the federal lawsuit requiring it to pay a \$500,000 civil penalty and the Commission's issuance of its cease-and-desist order.

## Regulation Fair Disclosure Cases

*In the Matter of Raytheon Company, et al.; In the Matter of Secure Computing Corporation, et al.; In the Matter of Siebel Systems, Inc.; Report of Investigation in the Matter of Motorola, Inc.*<sup>17</sup> The Commission instituted and settled three separate administrative proceedings against Raytheon Company

and its CFO Franklyn Caine, Secure Computer Corporation and its CEO John McNulty, and Siebel Systems, Inc., alleging violations of Regulation FD. The Commission alleged that the defendants disclosed material non-public information in violation of Regulation FD. The defendants each consented

to the entry of an order finding that they violated the periodic reporting provisions of the federal securities laws and Regulation FD, and ordering them to cease and desist from committing or causing any violations and future violations of these provisions. The Commission also filed and settled a related civil action against Siebel, concerning the same conduct, and Siebel agreed to an injunction

and to pay a \$250,000 civil penalty. Finally, the Commission issued a Report of Investigation concerning disclosures made by Motorola, Inc., that the Commission deemed to violate Regulation FD. The Commission issued the Report, rather than filing an enforcement proceeding against Motorola, because of Motorola's demonstrated reliance on counsel.

## Broker-Dealer Cases

*Analyst Research Global Settlement.*<sup>18</sup> The Commission, along with the New York Attorney General, the NYSE, and NASD, and other state securities regulators, filed and settled enforcement actions against Bear, Stearns & Co. Inc.; Credit Suisse First Boston LLC; Goldman, Sachs & Co.; Lehman Brothers, Inc.; J.P. Morgan Securities, Inc.; Merrill Lynch, Pierce, Fenner & Smith, Inc.; Morgan Stanley & Co., Inc.; Citigroup Global Markets, Inc., f/k/a Salomon Smith Barney, Inc.; UBS Warburg LLC; and U.S. Bancorp Piper Jaffray, Inc. The actions allege that from approximately mid-1999 through mid-2001 or later, all of the firms engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts, and that the firms failed to manage the resulting conflicts of interest in an adequate or appropriate manner. In settling the actions against them, the firms agreed to make payment totaling \$1.4 billion for the following purposes:

- \$875 million in penalties and disgorgement, the federal portion of which will be put into a fund to benefit customers of the firms;
- \$432.5 million to fund independent research; and
- \$80 million to fund and promote investor education.

The regulators also filed and settled civil and administrative proceedings against Jack Grubman, a former managing director of Salomon Smith Barney, Inc. and the lead research analyst for Salomon's telecommunications sector, and Henry Blodget, a former managing director at Merrill Lynch and senior research analyst for Merrill's Internet sector for issuing fraudulent and misleading research reports. Both Grubman and Blodget agreed to an injunction, the respective

payment of \$15 million and \$4 million in penalties, a censure, and a permanent bar from associating with any broker, dealer, or investment adviser.

*In the Matter of Robertson Stephens, Inc.*<sup>19</sup> The Commission filed and settled a civil action against Robertson Stephens, Inc., a San Francisco-based brokerage firm and investment bank, relating to the firm's allocation of shares in initial public offerings (IPOs) during 1999 and 2000.

The Commission alleged that Robertson Stephens wrongfully obtained millions of dollars from over 100 customers by allocating shares of "hot" IPOs to these customers and receiving, in return, profits—in the form of excessive commissions or markdowns—made by these customers on their IPO stock. In addition to an injunction, Robertson Stephens agreed to pay \$23 million in disgorgement and a \$5 million civil penalty.

### Books and Records Violations, Fraudulent Reporting, and Unregistered Broker-Dealers

*In the Matter of Deutsche Bank Securities, Inc., et al.*<sup>20</sup> The Commission, along with the NYSE and NASD, filed and settled administrative proceedings against five broker-dealers for violations of recordkeeping requirements concerning e-mail communications. The Commission found that each firm—Deutsche Bank

Securities Inc.; Goldman, Sachs & Co.; Morgan Stanley & Co. Inc.; Salomon Smith Barney, Inc.; and U.S. Bancorp Piper Jaffray, Inc.—had inadequate procedures and systems to retain and make accessible e-mail communications. The firms consented to the imposition of fines totaling \$8.25 million (\$1.65 million per firm).

### Mutual Funds and Investment Adviser Cases

*In the Matter of Prudential Securities, Inc.; In the Matter of Robert Ostrowski, et al.*<sup>21</sup> The Commission instituted two related enforcement proceedings, the first a settled proceeding against Prudential Securities, Inc., and the second against Robert Ostrowski and Rees T. Harris, a registered representative and a supervisor associated with Prudential Securities, Inc. during the relevant period. In the litigated proceeding, the Division of Enforcement alleges that Ostrowski defrauded investors by selling them shares in certain classes of mutual funds without disclosing that less expensive share classes in the same mutual funds were

available, and that Harris failed reasonably to supervise Ostrowski. In the settled proceeding, the Commission found that Prudential had inadequate systems in place to effectively monitor and enforce its policies and procedures relating to sales of different classes of mutual fund shares. The Commission censured Prudential and ordered it to pay \$82,000 in disgorgement and interest, and \$300,000 in civil penalties, and to comply with certain remedial undertakings.

*In the Matter of Theodore Charles Sihpol, III.*<sup>22</sup> The Commission filed an enforcement action against

Theodore C. Sihpol III, a former broker at Banc of America Securities LLC (BAS) (a subsidiary of Bank of America Corporation), alleging that Sihpol played a key role in enabling certain hedge fund customers to “late trade” mutual fund shares.

The Commission also alleged that Sihpol falsified, altered, destroyed, or evaded the creation of books and records that BAS was required to create, maintain, and preserve. The action is pending before an administrative law judge.

## Insider Trading Cases

*SEC v. Peter J. Davis, Jr., et al.*<sup>23</sup> The Commission filed related enforcement actions arising from trading in U.S. Treasury 30-year bonds minutes before the Department of the Treasury announced that it would no longer issue such bonds. Peter Davis, the individual who misappropriated the Treasury Department information, Goldman Sachs & Co., and Massachusetts Financial Services Company agreed to pay over \$10.3 million to settle the Commission’s actions against them.

*SEC v. Martha Stewart, et al.*<sup>24</sup> The Commission filed an action against Martha Stewart, CEO of Martha Stewart Living Omnimedia, Inc., and Peter Bacanovic, a former registered representative associated with Merrill Lynch, alleging that Stewart sold stock in ImClone Systems, Inc. after learning material non-public information communicated from Bacanovic. The Commission is seeking injunctions, civil penalties, an officer and director bar against Stewart, and an order requiring Stewart and Bacanovic to disgorge, jointly and severally, the losses avoided by Stewart.

## Outlook for 2004

Our main objectives are to:

- Continue to maintain a presence in all major core areas of enforcement, including violative conduct in the financial services and mutual fund sectors, financial fraud, market manipulation, insider trading, and offering fraud;
- Expand Division proactive, forward-looking efforts.
- Continue our litigation program in the face of an increasing number of defendants choosing to litigate, the increasing

complexity of the Commission’s enforcement actions, the increase in emergency and subpoena enforcement actions, and the Commission’s efforts to increase sanctions imposed on defendants.

- Wherever practical, continue to seek to return recovered funds to defrauded investors; as a result of the “Fair Funds” provisions of the Sarbanes-Oxley Act, amounts paid as penalties may now also be used to reduce investor losses.